



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

OFFICE OF THE CHIEF COUNSEL

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The Honorable John Kline  
Member, U.S. House of Representatives  
101 West Burnsville Parkway, Suite 201  
Burnsville, MN 55337

Attention:

Dear Congressman Kline:

This letter responds to your inquiry dated August 27, 2012, on behalf of your constituent. Your constituent requests information about the tax implications of a foreclosure sale of a home for less than the mortgage balance.

A foreclosure is treated as a sale from which a taxpayer may realize gain or loss. If the mortgage was a nonrecourse debt where the taxpayer was not personally liable, the taxpayer would include the amount of the cancelled debt in calculating the gain, if any, from the foreclosure sale. This is true even if the fair market value of the home is less than the outstanding loan balance at the time of the sale. A taxpayer may be eligible to exclude gain on the foreclosure sale from gross income if, during the 5-year period ending on the date of the sale, the taxpayer owned and used the home as his or her main home for at least 2 years.

If the mortgage was a recourse debt where the taxpayer was personally liable and the outstanding loan balance was more than the fair market value of the property, a taxpayer may realize ordinary income from the cancellation of debt if the lender cancels all, or part, of the remaining loan balance after the foreclosure sale. A taxpayer must report this income on his or her tax return, unless certain exclusions apply.

A taxpayer may exclude a canceled recourse debt from income if he or she was insolvent immediately before the cancellation. Insolvency means that the total of all of a taxpayer's liabilities was more than the fair market value of all of the taxpayer's assets immediately before the cancellation.

A taxpayer may also exclude canceled recourse debt from income if the indebtedness arose from a mortgage that he or she took out to buy, build, or substantially improve his

or her main home, and the taxpayer's main home secures the mortgage. This exclusion also applies to any debt secured by the taxpayer's main home to refinance a prior mortgage that the taxpayer used to buy, build, or substantially improve his or her main home, but only up to the amount of the prior mortgage principal balance before the refinancing. This exclusion from income applies only to indebtedness discharged before January 1, 2013.

For your information, I am enclosing a copy of Publication 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments (for Individuals)*, which discusses this information in more detail. I hope this information is helpful. If you have any questions, please contact \_\_\_\_\_ or me at \_\_\_\_\_.

Sincerely,

Michael J. Montemurro  
Chief, Branch 4  
Office of Associate Chief Counsel  
(Income Tax & Accounting)

Enclosure